

Impact of BOJ's Policy Decision to the Japanese Equity and Currency Markets

- Japanese equity and USD/JPY went volatile when BOJ introduced “Quantitative and Qualitative Monetary Easing with a Negative Interest Rate”.
- BOJ's Current Account Balance will be divided into three tiers, to one of which a negative interest rate will be applied. BOJ intends to increase lending by financial institutions.
- Although we need to watch carefully the impact of BOJ's policy, change of market direction can be expected as external environment has slightly stabilized.

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BOJ decided to introduce “Quantitative and Qualitative Monetary Easing with a Negative Interest Rate” at the Monetary Policy Meeting (MPM) held on 28th and 29th of January, 2016. This announcement was taken as a surprise by the market, as BOJ Governor Kuroda had denied any consideration of introducing negative interest rate for the near future at the House of Councilors' Audit Committee held on 21st January. Nikkei 225 skyrocketed to JPY 17,638.93 and JPY depreciated against USD to 121.42 after the announcement.

Later, markets were traded sideways with volatility, temporally overwhelmed by profit taking activities which led to a sharp fall of the Japanese equity market and weaker JPY against USD, but soon were bought back. According to the Outlook for Economic Activity and Prices (Outlook Report) released on the same day as MPM, CPI (all items less fresh food) for FY2016 was revised down to + 0.8% YoY from + 1.4% YoY and the timing of achieving the price stability target was postponed to around the first half of FY2017 from around the second half of FY2016 (Diagram 1).

"Diagram 1: Inflation Outlook of BOJ's Outlook Report"

	Forecast as of 30th October, 2015	Forecast as of 29th January, 2016
Inflation Outlook of FY2016	+ 1.4%	+ 0.8%
Crude Oil Price (Dubai) Recent Price	US\$50 per barrel	US\$35 per barrel
Crude Oil Price towards the end of the projection period	Low US\$60s	High US\$40s
Time when contribution of energy price becomes zero	Second half of FY2016	Around first half of FY2017
Timing of achieving price stability target	Around second half of FY2016	Around first half of FY2017

(Note) Outlook of Inflation is year-on-year rate of change in the Consumer Price Index (all items less fresh food).
(Source) SMAM, based on BOJ's materials and data.

"Diagram 2: Three-tier System of BOJ's Current Account Balance"

Name of Tiers	Applied Rate	Explanation
i) Basic Balance	+0.1%	Average outstanding balance from January 2015 to December 2015 (Benchmark reserve maintenance periods)
ii) Macro Add-on Balance	0%	Outstanding amount of required reserves, outstanding amount related to the Loan Support Program etc., addition at appropriate timing
iii) Policy-Rate Balance	-0.1%	Outstanding balance in excess of the amounts outstanding of i) and ii) combined
If financial institutions' cash holdings increase significantly from those during the benchmark reserve maintenance periods, the increased amount will be deducted from balance in ii) and if it surpasses balance of ii), the amount in excess will be further deducted from balance in i).		

(Source) SMAM, based on BOJ's materials.

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BOJ also pointed out in its Outlook Report that risk of negative impact on trend of inflation is rising, as financial markets are getting unstable due to falling crude oil price and the China risk. I assume that this was the true reason of BOJ's policy decision, at this time. BOJ declared that they will pursue monetary easing by making full use of possible measures in terms of three dimensions; "quantity", "quality" and "interest rates". However, this time "quantity" and "quality" were unchanged.

The introduction of a negative interest rate was decided by a narrow margin of 5 votes to 4 at the MPM. As to details of the operating scheme, BOJ's Current Account Balance will be divided into three tiers, namely i) Basic Balance, ii) Macro Add-on Balance and iii) Policy-Rate Balance to which interest rates of + 0.1%, 0% and - 0.1% will be applied respectively (Diagram 2). If financial institutions intend to avoid negative interest rate, the only measure is to increase lending, as increase in holding cash means decrease in tier i) and ii). I think this was BOJ's real purpose of introducing the negative interest rate.

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In terms of impact to the market, I believe that there could be a possibility of appreciation by foreign investors on BOJ stepping into negative interest rates. In addition, BOJ negated any possible end of their monetary easing policy by indicating the possibility of further cuts of the negative interest rate whenever BOJ thinks necessary. JGB's yield fell sharply across the curve after BOJ's announcement. I believe the risk of sharp appreciation of JPY has subsided as such move in yields will be considered as an event of JPY to depreciate.

Turning our eyes on external factors, excessive concern over Chinese RMB has moderated as its mid-point rate against USD has stabilized for the past few days. Meanwhile, some signs of changes in external risk factors can be observed as crude oil price has bottomed out and is rising gradually over expectation of agreement of oil production cuts amongst oil producing countries. Although, cautious stance must be maintained as external factors are still unpredictable and the impact of negative interest rates are yet to be carefully watched, I tend to believe that gradual change of market direction can be expected going forward.

* Please note that this report is a translation of Japanese report written on 29th January, 2016.

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